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Chile: Implications of the Worsening Trade and Payments Position ER IM 75-8

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Chile: Implications of the Worsening Trade and Payments Position

KEY JUDGMENTS

Chile faces a large balance-of-payments deficit this year.

- Lower copper prices and participation in a CIPEC export-restriction scheme are likely to cut total export earnings 30%.

- Rising world market prices for manufactures are increasing Chile's import costs by about 7%.

- Foreign aid is very low, mainly because of international distaste for the military government.

- Although the junta has applied to the Paris Club for debt relief, it stands little chance of getting its 1975 debt service payments of US $710 million voluntarily reduced by more than $226 million.

Chilean foreign reserves are minuscule, and extensive commercial financing is precluded by Chile's already enormous foreign debt. Santiago thus would be forced to slash imports from the current rate by as much as $1 billion – a 45% reduction in volume from 1974 – if it were to fully meet its debt service commitments. So far, no steps to restrict imports have been taken.

Despite its strong desire to improve Chile's international credit standing, the military government may default on 1975 debt service payments due to most Communist and some West European countries. Default is most likely on the obligations to countries that are least willing to provide new aid or show flexibility in debt negotiations.

The potential foreign exchange savings from defaulting on debt service payments are probably not more than $135 million, because less selective defaults would irreparably damage the country's international credit position. Some

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Note: Comments and queries regarding this memorandum are welcomed. They may be directed to [redacted] of the Office of Economic Research, Code 143, Extension 5079.

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additional relief probably will be available through a small bank loan the government is now seeking. Chile nevertheless will probably have to slash imports by $800 million, or some 35% in volume, in 1975. A reduction of this magnitude will reverse the economic recovery after the Allende period and derail government economic reforms.

- Real GDP may decline during the latter part of the year by as much as 10% at an annual rate (3%-4% in 1975), with industry suffering more than this.

- Further rises in unemployment and declines in real wages will increase public unrest.

- The government will be forced to increase its intervention in the economy, and pressure from within the military will mount for the attack on Chile's triple-digit inflation to be abandoned.

DISCUSSION

Economic Gains in 1974

1. By the end of 1974, Chile's economy was recovering from the shambles of the final year of Allende government and the September 1973 military takeover. Labor discipline had been restored, essential services reinstated, and price and labor controls and other regulations that fettered production largely removed. Real GDP grew 5% in 1974, regaining the 1972 level (see Figure 1). Although the government's anti-inflation program increased unemployment and lowered real wages, it succeeded in only halving 1973's 700% inflation rate.

2. Recovery was most helped by a hike in export earnings of more than one-half, a sizable inflow of foreign economic assistance, and refinancing by the Paris Club of 50% of the 1974 Chilean debt service payment of $812 million. Record world copper prices – averaging 93 cents a pound, compared with 81 cents in 1973 -- and a large rise in copper export volume were central to the export recovery. Export receipts plus increased foreign assistance permitted a near-doubling in the volume of imports of fuels, raw materials, and semi-manufactured goods despite much higher prices for oil, grain, and other goods. An 80% cumulative devaluation of the escudo during the year encouraged exports and discouraged nonessential imports. Although the trade deficit was slashed by 30% from the 1973 level, net foreign reserves slipped by about $110 million, mainly reflecting disappointingly small inflows of private capital.

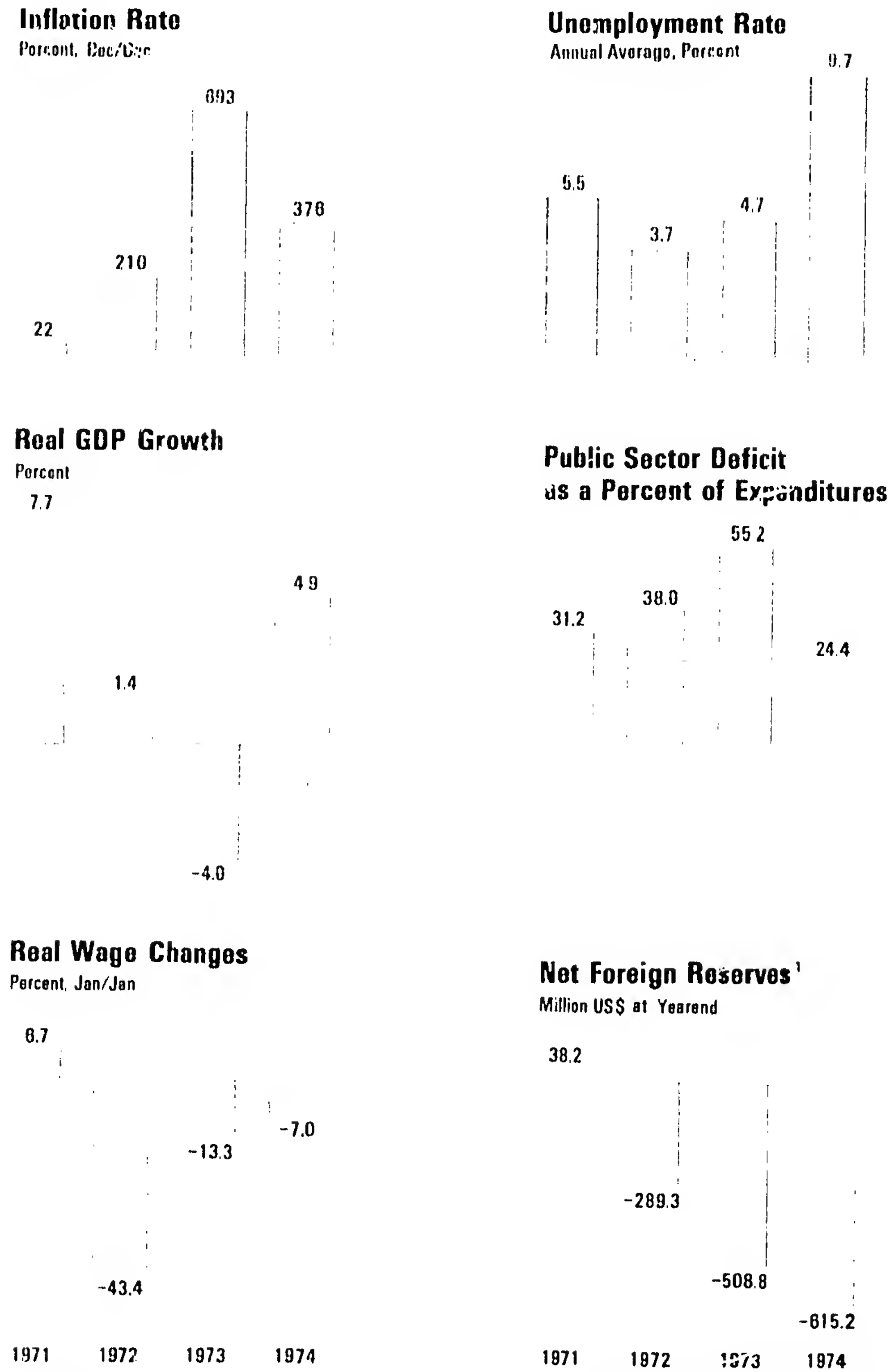
Poor World Copper Price Outlook in 1975

3. Continued recovery in 1975 is now threatened by the depressed world copper market. Recession-induced declines in the consumption of copper by the industrial nations, growing inventories, and a rising supply of scrap have kept the London Metal Exchange price fluctuating close to 60 cents a pound for the first three months of 1975, following a precipitous fall from the April 1974 peak of $1.52 a pound.

4. Plans by Chile, in cooperation with the other CIPEC countries, to reduce exports by 15% probably will forestall further substantial price declines this year. They will not raise prices significantly, however. Accumulated stocks must be reduced before new production can be sold at higher prices. An average world copper price of 60-65 cents a pound appears to be the best that Chile can hope for this year, compared with 93 cents a pound in 1974.

CHILE: Economic Indicators

Figure 1



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1. Total reserves minus short term liabilities.

Impact on Export Earnings

5. Chile's copper export earnings will be down about two-fifths in 1975. CIPEC's control scheme will reduce the 1975 volume of Chilean copper exports in two steps to 782,000 tons from 887,000 tons in 1974. At a world price of 62 cents a pound, 1975 earnings would be about $920 million, compared with $1,560 million last year.

6. Although prospects for earnings from exports other than copper are good, these exports contribute only 36% of the total. Agricultural exports–chiefly pulses and fruits–will benefit from a better harvest, removal of export restrictions, and government efforts to open new markets. Nitrate exports will be strengthened by increased world demand for fertilizer and rehabilitation of processing facilities. Prospects for such export-oriented industries as cellulose and paper also have improved. Earnings from non-copper exports should reach about $525 million in 1975, about 10% above last year. Total 1975 exports nonetheless will not exceed $1.5 billion, compared with $2 billion in 1974.

Soaring Trade Deficit

7. While export earnings are falling, imports continue to rise. A second successive good harvest and lower grain prices are reducing the value of food imports. But, although the anti-inflation program is holding down demand for other imports, their prices are rising and total import outlays are still increasing slowly. If recent import trends continue, Chile is heading for a thumping trade deficit of $900 million, compared with only $200 million last year (see Figure 2).

Slipping Capital Account

8. There is no chance Chile could finance a trade deficit of anywhere near $900 million. It would have to retrench even if foreign creditors were favorably inclined. But most of Chile's creditors are unwilling to provide any relief to the military government in the light of the repeated charges of violations of human rights. Thus, deliveries of official aid, which rose a little last year after the fall of the Allende government, will drop by about $130 million this year. Only US bilateral aid and assistance from international institutions totaling $267 million will remain, as shown below:

	Million US $
IMF	187
World Bank	40
US AID and PL-480	30
IDB	10

9. The outlook for private capital inflows remains poor. Despite extensive promotional effort, the government has been unable to attract a significant movement of direct foreign investment. Thus, a small net inflow of some $150 million in private capital—mainly supplier credits—is the best that can be expected for the year. Chile probably has already acquired as much as $200 million in supplier credits to cover the January-March payments deficit. As the situation deteriorates, however, we estimate that as much as $50 million of them could be offset by capital flight.

Disappointing Debt Relief Prospects

10. We estimate that less than one-third of Chile's $710 million foreign debt service payment will be voluntarily renegotiated in 1975 (see Table 1). Santiago probably will apply to the Paris Club for a rollover of a substantial share of the $565 million due members this year. Club guidelines, however, define only about $270 million in obligations as eligible for renegotiation. Of this amount, Club precedent dictates that only 95%, or $256 million, will actually be considered for renegotiation. About $50 million of this amount probably cannot be rescheduled because the United Kingdom and Italy intend to boycott the renegotiations, and the

Figure 2

CHILE: Trade Balance

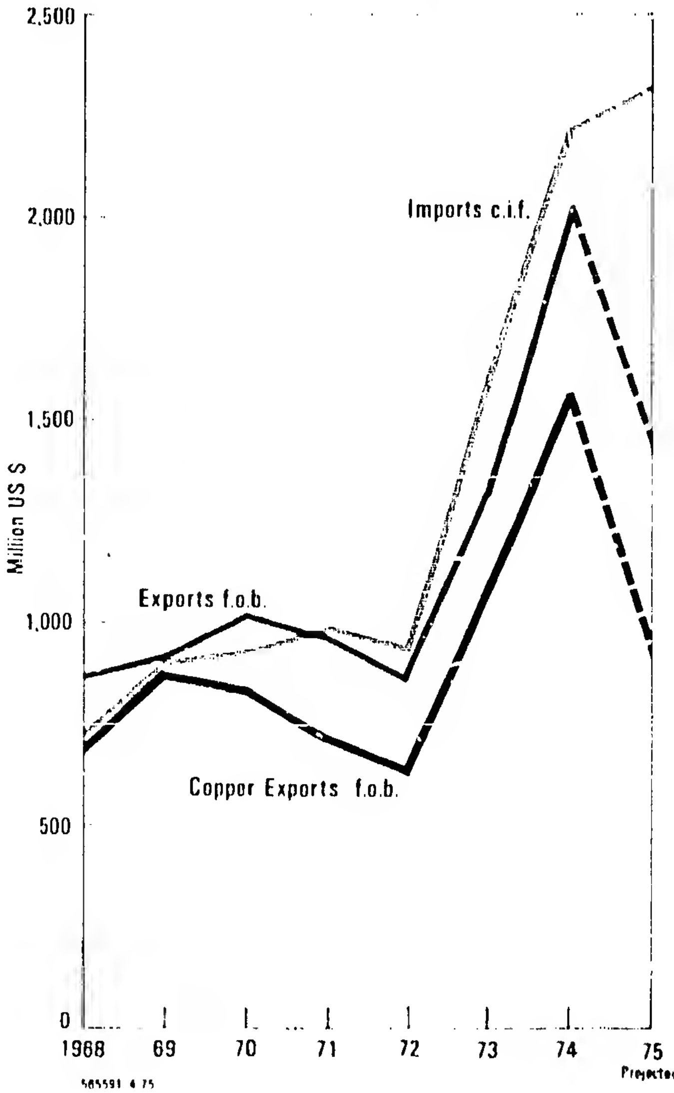

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Table 1

Chile: Summary of External Debt Service Payments

Million US $

	Paris Club Countries					
	United States	Other Member Countries	Total	International Institutions	Other	Total
1974						
Debt service payments due	357.0	340.3	697.3	52.8	62.1	812.2
Carried over from 1973	104.7	131.6	236.3	21.5	12.9	270.7
Falling due in 1974	161.9	193.5	355.4	31.3	47.3	434.0
Other[1]	90.4	15.2	105.6	....	1.9	107.5
Estimated payments	....	....	291.3	96.7		388.0
Debt relief	....	....	406.0	18.2		424.2
1975						
Debt service payments due	323.0	241.5	564.5	54.1	91.6	710.2
Required payments	....	....	357.6	54.1	72.6	484.3
Expected voluntary debt relief	....	...	206.9	....	19.0	225.9

1. Including compensation payments due in 1974 for nationalized properties and estimated interest payments on refinancing loans from the 1974 renegotiation.

United Kingdom probably will succeed in persuading three other European members to join them.

11. The remaining $145 million due in 1975 represents obligations to international financial agencies, Communist countries, and Latin American countries. Payments due the international financial agencies are not renegotiable. Appeals to roll over the $50 million due the Communist countries probably will fall on deaf ears. Although relief from the Latin American countries is likely, it could total only $19 million.

Closing the Payments Gap

12. Chile's impending balance-of-payments crunch has put the military government in a difficult position. The soaring potential trade deficit combined with a rising services deficit and a smaller prospective capital account surplus will leave a payments gap of about $1 billion (see Table 2). Foreign reserves, already $615

Table 2

Chile: Balance of Payments

Million US $

	1973	1974	1975 Projected	1975 After Corrective Measures
Exports (f.o.b.)	1,325	2,037	1,445	1,445
Copper[1]	1,088	1,560	920	920
Other mining	102	150	170	170
Agriculture and fishing	24	55	60	60
Industrial products	111	272	295	295
Imports (c.i.f.)	1,608	2,234	2,330	1,545
Foodstuffs	595	472	330	330
Fuels and lubricants	70	348	400	360
Capital goods	285	338	390	745
Materials and intermediate goods	544	978	1,100	
Other	114	98	110	110
Trade balance	-283	-197	-885	-100
Net services and transfers	-190	-244[2]	-290[3]	-290[3]
Current account balance	-473	-441	-1,175	-390
Private capital	116	148[4]	150	150
Official capital	-64	-242	-223	-223
Drawings	341	396[4]	267	267
Amortization	-405	-638	-490	-490
Debt relief	337	424	226	360[5]
Short-term capital	[6]	[6]	....	103
Capital account balance	389	330	153	390
Reserve movements (increase +)	-84	-111	-1,022	....

1. Net copper exports assume a discount of 8.5 cents per pound from the price of 62 cents for copper wirebar c.i.f. Europe, to allow for quality deviation, freight, and insurance.
2. Including $174 million interest payments on foreign debt.
3. Including $220 million interest payments on foreign debt.
4. Excluding a $550 million debit to private capital and a corresponding credit to official capital representing the government's assumption of responsibility for paying compensation to the former owners of properties nationalized by the Allende government.
5. Including default of $134 million.
6. Included in private and official capital.

million short of short-term foreign liabilities, cannot provide much help. Large-scale commercial borrowing is precluded by both Chile's already enormous foreign debt and low reserves.

13. Despite its strong desire to improve Chile's credit standing, the military government probably will choose to default on the debt service payments due most of the Communist countries to help close the gap. Faced by refusal of some Paris Club members, especially the United Kingdom and Italy, to roll over their debt, it also may default on payments to them. In addition, Santiago is seeking and probably will get short-term commercial funds to cover the $103 million in the Paris Club obligations that represent compensation payments for nationalized US properties. These steps at best would still leave a payments gap of $800 million.

14. Santiago unquestionably is considering a much more extensive default of its 1975 debt service obligations. By defaulting on all but payments due the international financial agencies, for example, the military government could reduce the payments gap by an additional $195 million. About $145 million of this amount is due four major creditors: the United States, West Germany, France, and Japan. The junta conceivably might default on as much as another $50 million in obligations due on a large number of small, mostly European credits. We judge, nevertheless, that it would not risk defaulting on payments due the four major creditors, because the relatively small gain would not compensate for the disastrous effect default could have on Chile's chances for obtaining new credits in subsequent years.

15. Assuming no further defaults, the military government will be forced to close the remaining $800 million of the gap by slashing imports. This would mean a cut of $700 million from the 1974 level, some 35% in volume. Imports of non-food consumer goods could be cut but are small (5% of the total). Because of a good 1974 harvest, food imports probably are already down about 20% in volume from last year, and further substantial cuts would be politically dangerous. Rationing of gasoline – now under consideration – probably could permit a 10% reduction in oil imports, saving some $40 million.

16. The remaining $750 million in savings must come out of imports of raw materials, intermediate products, and capital goods – a cut of about 50% from the 1974 level in volume. Although inventories built up early in 1974 when imports were liberalized can absorb some of the cut – the US Embassy estimates that inventories could be reduced by $150-$200 million – there would be no way to avoid widespread shortages, sharp declines in output, and unemployment.

Economic Impact

17. The unprecedented import curtailment of the magnitude we believe may be necessary in 1975 would be extremely disruptive to the still weak Chilean

economy. Supplies of raw materials, intermediate products, and capital goods will be down to the 1968 level, when real industrial, mining, and construction output totaled only about 80% of the 1974 level. Because no relief is likely before mid-1976, when economic recovery in the industrial nations may begin to push world copper prices back up, Chilean output and employment almost certainly will be forced down sharply.

18. In the second half of 1975, real GDP, currently stagnant because of the anti-inflation program and the reduction in copper output under the CIPEC agreement, seems likely to drop at an annual rate of as much as 10%. This could reduce GDP for the calendar year by 3%-4%. If the $50 million worth of fertilizer imports required for farming is maintained, agriculture would be the only economic sector likely to register an increase in output. Severe shortages of raw materials and semi-manufactures could reduce output in manufacturing by as much as 25%, and by 5%-10% in mining and construction (annual rates). The swollen services sector, accounting for about half of total output, will be dampened by the declines in mining and manufacturing.

19. Our estimate for real GDP in 1975 differs sharply from a recent IMF forecast, which envisions a 5% gain. The difference reflects mainly higher IMF projections of earnings from copper exports and of official short-term and long-term capital. On this basis, the IMF believes that a reduction of only $260 million in imports from last year will be required and that this can be made with only a 5% decline in spending for imports of materials, intermediate products, and capital goods. We believe the IMF estimates and analysis are much too optimistic.

20. Despite the economic decline we project, the regime clearly will try for a time to hold to its anti-inflation program. Indeed, it may consider strengthening it by further restrictions on nominal wage rates and increased budget austerity. Except for a rise in debt service payments, government expenditures are slated to remain at the 1974 level. Revenue from a new value-added tax and stronger tax collection efforts will nearly offset increased debt service payments and falling revenues from copper, and the government deficit probably will grow only slightly. The junta also will persist in its efforts to trim the government payroll, thus adding to unemployment.

21. Later in the year, however, the deteriorating economic situation will place serious strains on the programs to curb inflation and reduce government intervention in the economy – programs that have constituted the main hope for eventually putting Chile's ailing economy on a sound footing. Import liberalization will have

to be terminated, and foreign exchange will have to be rationed. Moreover, large rises in unemployment and declines in real wages will cause mounting public unrest and put strong pressure on the government from within the military to expand public employment and to take other public welfare measures that in effect will constitute abandonment of its programs.